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Tariff and Tax Reform

Do World Bank Recommendations Integrate Revenue and Protection Objectives?

Anand Rajaram

A selective review of the World Bank's recommendations on tariff reform suggests that there is scope to improve the design of these recommendations to reflect concerns regarding *revenue* as well as *protection*.

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This paper — a product of the Public Economics Division, Country Economics Department — is part of a larger effort in the department to improve the design of policies to achieve reform objectives. Copies of the paper are available free from the World Bank, 1818 H Street NW, Washington, DC 20433. Please contact Peggy Jean Pender, room N10-067, extension 37851 (November 1992, 28 pages).

Tariff reform aimed at reducing domestic protection and the bias against exports holds the threat of widening the fiscal deficit by causing tariff revenue to decline. Because the success of an adjustment program depends critically on the correction of fiscal imbalances to achieve stabilization, tariff reforms must be coordinated with tax policy recommendations to develop alternative revenue sources. Conversely, the tariff reforms must eliminate the protective elements of domestic tax structures if they are to truly achieve their protection objectives.

Rajaram reviews the extent to which the Bank's analysis and tariff recommendations in twelve countries (Bangladesh, Ghana, Indonesia, Jamaica, Malawi, Morocco, Pakistan, the Philippines, Thailand, Turkey, Zaire, and Zambia) reflected such an integrated framework. He focuses on (1) the revenue impact of tariff reform, (2) the effect of domestic indirect taxes on protection, and (3) the structure of protection. The review is admittedly selective and the

attempt is to capture the reasoning behind "typical" Bank recommendations.

Rajaram finds that the quality of analysis underlying Bank recommendations in this regard is highly uneven. The following broad conclusions are indicated:

- Revenue concerns are often not adequately addressed in the design of tariff proposals. In a few cases this neglect may have contributed to policy reversal.
- The protective effect of domestic indirect taxes is often not recognized and thus not incorporated into the reform of the structure of protection.
- Although there is little consensus on a desirable tariff structure, in a few cases the Bank has recommended a uniform nominal tariff. This could be seen as the logical culmination of attempts to narrow the range of tariffs.

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TARIFF AND TAX REFORMS

Do World Bank Recommendations Integrate Revenue and Protection Objectives?

Anand Rajaram*

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Contents

	<i>page</i>
Summary.....	i-ii
I. Introduction.....	1
II. Issues.....	4-22
a. Tariffs and Revenue.....	5
b. Protection and Domestic Taxes.....	10
c. Structure of Tariffs.....	16
III. Conclusion.....	22
IV. References.....	27

SUMMARY

1. The liberalization of trade has been a significant plank in the Bank's attempt to reform the policy environment in developing countries. The reduction of tariffs in this context is prompted mainly by the desire to lower the level and structure of protection to domestic industries and to reduce the corresponding bias against exports. However, trade taxes constitute a major source of revenue for many countries and recommendations to reduce protection necessarily have revenue implications. Since the success of an adjustment program is often seen to depend in a critical way on the correction of fiscal imbalances, it is imperative that the revenue consequences of tariff reform be anticipated. Thus, where tariff reductions are expected to lead to revenue losses, trade policy advice must be integrated with tax policy recommendations to develop alternative revenue sources.

2. Conversely, attempts to reform the structure of protection cannot ignore the role of the domestic indirect tax structure since the latter can and, in many of these countries, does affect protection. A domestic sales tax that applies at a higher rate on imports than on domestic goods has a protective effect similar to a customs duty and must be incorporated into the design of tariffs. Protection can also emerge from more subtle aspects of the application of domestic taxes to imports and local products.

3. This paper conducts a selective review of the extent to which trade policy and tax policy concerns are integrated in recommendations by the Bank. The review covers twelve countries: Bangladesh, Ghana, Indonesia, Jamaica, Malawi, Morocco, Pakistan, Philippines, Thailand, Turkey, Zambia and Zaire. In addition to gauging the extent to which tariff proposals adopted a 'public finance' perspective as noted in (2) and (3) above, the paper attempts to describe the typical Bank recommendations as they relate to tariff structure and the tariff treatment of intermediate inputs.¹

4. The evidence on the revenue impact of the Bank's trade proposals suggests that there is scope for improvement in developing alternative revenue sources. The Bank has often proposed to replace QRs with tariffs and to reduce tariffs. The response to short-term revenue concerns in the light of these proposals was that revenue would not decline by much, if at all. The reason for this assessment was that while tariff reductions would lead to some revenue loss, it would be offset by additions to the tariff base caused by a) QR items being transferred to the tariff list, b) removal of existing exemptions, and c) increased imports through legal channels. In a few cases, as in Zaire, the revenue loss due to reduction of the maximum tariff was expected to be more than offset by an increase in the minimum tariff. Sometimes this optimistic reasoning was buttressed by model simulations that indicated the revenue effect of alternative scenarios. On occasion the Bank has recommended alternative tax measures in an effort to offset revenue decline due to tariff reductions. However, in a few cases this proved to be inadequate and the resultant revenue shortfall exacerbated the fiscal imbalance and contributed to policy reversal.

5. The Bank has addressed the longer-term need to reduce the reliance on trade taxes for revenue on only a few occasions. In one case it recommended shifting the revenue function to the domestic indirect tax by broadening the base and elasticity of this tax while reducing tariffs on imports. In another, it recommended moving towards the development of a manufacturing-cum-import

¹ As some time has elapsed since this study was conducted, the paper does not pretend to be current with reforms and developments that have occurred after 1989 for the countries in the sample. It nevertheless offers a useful review of Bank recommendations in this area.

stage VAT which would shoulder the burden of the revenue function by taxing consumption rather than imports and inputs.

6. In a large number of cases, the Bank did make reference to the need to "harmonize" the domestic tax treatment of imports and domestic production. The asymmetric treatment of domestic and imported goods under the domestic indirect tax system implies that the domestic indirect tax may add to or offset the protective effect of customs duties. In most cases this issue was not addressed adequately since the protective effect of domestic taxes can occur for reasons other than the obvious one of differences in statutory tax rates. In the case of Zambia the Bank recommended "unification of the sales tax on imports and domestic products at 15%" without noting that the sales tax would apply to imported inputs and not to domestic input producers. The sales tax on imports thus added 15% protection to import competing firms over and above that provided by the customs duty of 10% on imported inputs. Given this lack of analytical thoroughness even in cases where the issue was signalled, the presumption in cases where the issue was not discussed should be that the problem was not identified rather than that it did not exist.

7. The review suggests that there is superficial consistency in the broad thrust of the recommendations on tariff structure. In almost all cases the Bank proposed replacing QRs with tariffs and suggested that the level and the range of nominal tariffs be reduced. Aside from this broad similarity, however, the reports reviewed were very uneven in their analysis and recommendations. In most cases the Bank did not spell out a long term objective of reform beyond the standard prescription of reducing the level and range of ERPs while in a few it went so far as to indicate that the ultimate objective of tariff policy should be a uniform nominal tariff.

8. There is considerable variation in the recommended tariff treatment of raw material and intermediate inputs reflecting opposite concerns regarding the structure of protection. In some cases the concern is with relatively high levels of tariff on imported inputs which is seen to retard the development of downstream industries while in others low tariffs on inputs is thought to prevent the development of upstream industries and/or provide excessive protection to downstream industries. In many instances the suggested treatment is to increase the tariff on inputs to narrow the ERP on final goods while ensuring that there is some tariff escalation, i.e. final goods are taxed at a higher rate than inputs. In some cases increasing the tariff on inputs while lowering the maximum tariff (on final goods) is a method to approach a uniform nominal tariff objective.

TARIFF AND TAX REFORMS

I. Introduction

Issues of trade liberalization are an important component of the Bank's policy recommendations to member countries. A major focus of trade liberalization is the dismantling of an existing pervasive system of trade controls - quantitative restrictions, import tariffs, export taxes, etc.- which distort the allocation of resources between tradeable and non-tradeable sectors and, within the tradeable sector, discriminate against exports.

The sequence of trade liberalization measures has been widely discussed and is reflected in most Bank recommendations. The typical strategy for achieving trade reforms is to begin with the replacement of QRs by tariffs, and in further stages to progress to reforms that restructure tariffs. The 1987 World Development Report notes that reducing the average level and the dispersion of the rates of protection are two objectives of tariff reform. Tariff reduction methods include: a) an equal proportional cut in all tariffs, b) equiproportional reduction of each tariff over a target level, c) higher proportional reduction of higher tariffs, d) lowering the highest rates to the next highest level, and so on, in what is described as the **concertina** method.

While considerable attention has been paid to the rationale and strategy for trade reform there is relatively little discussion of the integration of the recommendations for tariff reform with other dimensions of economic policy. This paper attempts to assess the extent to which the Bank integrates trade and tax policy concerns in its recommendations for trade liberalization. It is important to bring a 'public finance' perspective to bear on this issue for at least two reasons.

i. Trade taxes constitute a major source of revenue for many countries and recommendations to reduce protection have revenue implications. From the point of view of both short term and

long term revenue concerns, trade policy advice must be integrated with tax policy recommendations designed to develop alternative revenue sources.

ii. Conversely, attempts to reform the structure of protection cannot ignore the role of the domestic indirect tax structure since the latter can, and in many of these countries does, affect protection.

It is now recognized that one of the most important constraints to trade reform is conflict between trade policy recommendations and stabilization goals.¹ Since revenue shortfalls can seriously undermine macroeconomic programs as well as cause reversal of trade reform, it is important that recommendations to reduce tariffs be accompanied by well conceived policies designed to generate revenue in a less distortionary manner.

The purpose of this paper is largely factual and that is to assess the nature of Bank recommendations dealing with tariff reform and the extent to which it does or does not adopt such a public finance perspective. This perspective is discussed at length in Mitra (1992) but its essential insight can be indicated as follows: all developing countries have essentially two sets of instruments for the taxation of imports: (a) customs duties, and (b) sales taxes/value-added taxes. Discussion of the interaction between these two instruments is often missing in Bank analysis. In fact, few studies even provide the breakdown of sales tax revenue from imports and from domestic goods. The proportion of import taxes due to customs duties and the proportion due to domestic indirect taxes are often not reported even though this would be critical in the design of tariff and tax reforms.

Recognizing that imports can be taxed by these two instruments suggests that some matching of function and instrument may be desirable and it is here that the public finance perspective is useful. In principle, the customs duty alone should have the protection role while both customs

¹ World Bank (1989), p.33.

duties and the sales tax/VAT should function as revenue instruments.² Currently, many developing countries rely excessively on customs duties for revenue while also allowing elements of protection to be built into their domestic indirect tax. Coordinating the reform of this system of tariffs and domestic indirect taxes will require:

1. Ensuring that the sales tax/VAT is applied symmetrically to imports and domestic production so as to transfer the protection function to the customs duty. Both tax rate symmetry and appropriate definition of the tax base will be required to achieve this objective. Items not produced domestically should be subject to the domestic sales tax and not the customs duty.
2. Reducing protection per se requires matching the reduction in customs duty by an increase in sales tax/VAT rates. Since the sales tax applies to imported and domestic goods, revenue neutral reform can be attained by raising sales tax rates by a smaller amount than the decrease in customs duty.

This perspective also suggests useful rules of thumb for an integrated structure of taxes and tariffs that provide acceptable outcomes regarding efficiency, equity and protection. In addition, it provides a discussion of the desirable tariff treatment of intermediates and final goods. While the interested reader is referred to Mitra's paper for the detailed arguments we can indicate what such rules of thumb may be.

Tariff Structure:

- i. A uniform customs duty rate of no more than 10 to 15 percent.
- ii. Imported inputs entering export production should be exempted from the customs duty.

Domestic Indirect Tax:

- iii. A value-added tax, preferably of the consumption type, applied at a uniform rate to domestic production and imports but exempting agriculture, especially non-marketed food consumed by the poor. The VAT should feature a uniform rate whose level is determined by revenue requirements while applying a zero rate to exports.

² The following qualification is in order here: if the administrative costs of a sales tax/VAT are very high, it is conceivable that the customs duty is the optimal revenue instrument.

iv. Selected luxury items, both domestic production and import, should be taxed by excise taxes.

Export taxes:

v. Where a country's exports are subject to a quota or where world demand is inelastic, export taxes are appropriate.

These rules of thumb emerge from viewing taxes and tariffs in an integrated fashion. High uniform tariffs (say 30%) are inadvisable because they are likely to create problems in the administration of the duty exemption scheme for imported inputs used in export production.

II. Issues

This paper reviews specific trade and tax reform proposals and, where accessible, the underlying analysis. The countries chosen for this review include: Bangladesh, Ghana, Indonesia, Jamaica, Malawi, Morocco, Pakistan, Philippines, Thailand, Turkey, Zambia and Zaire. Since the Bank has been active in making recommendations on trade and tax policy in these countries, this sample allows us to study the extent to which revenue and protection considerations have influenced policy recommendations.³ The review, which is illustrative rather than comprehensive in its scope, focussed on the following questions:

A) Tariffs and Revenue: Were the revenue effects of tariff reform proposals anticipated and were complementary tax measures recommended to preserve revenue?

B) Protection and Domestic Taxes: Did the analysis recognize the protective effect of domestic indirect taxes? What measures were proposed to counter this effect?

C) Structure of Tariffs: What structure of tariffs was typically proposed? What was the recommended tariff treatment of intermediate good imports vis a vis final goods? Were uniform tariffs recommended?

³ Recommendations contained in recent Bank operations are not included in this review. For example, SAL-II for Morocco contains recommendations on trade reforms that are still under negotiation and thus not included in this review.

A. TARIFFS AND REVENUE

The record on whether adequate attention is paid to analysing the revenue impact of tariff proposals and if alternate sources of tax revenue are identified where indicated is very disparate. It indicates that Bank recommendations could be improved considerably. The discussion below classifies the country cases according to the extent to which the tariff recommendations were complimented by a concern for safeguarding revenue. In some cases trade reforms were viewed, in and of themselves, as revenue neutral (Indonesia, Zaire, Philippines). In a number of cases, proposals to safeguard revenue were neglected as concerns about reforming the structure of protection dominated the recommendations (Thailand, Pakistan, Turkey and Jamaica). In other cases adjustments to the domestic indirect tax regime were seen as necessary to offset expected revenue losses due to tariff reform. The domestic indirect tax recommendations ranged from ad hoc rate adjustments (Morocco) to more fundamental tax reform (Malawi, Bangladesh).

INDONESIA: While tariff reform and reduction has been a consistent theme of the Bank's recommendations to Indonesia, there is very little explicit discussion of the revenue effect of these measures. Two reasons may be cited for this observation; since Indonesia in the early eighties relied heavily on licensing restrictions to control imports, import tariffs initially provided only about 5 percent of government revenue. The shift from QRs to tariffs could thus have been expected to improve, rather than reduce, revenue generation from customs duties, eliminating the need for revenue safeguarding measures. Moreover, while discussion of a comprehensive tax reform in Indonesia had evidently considered the need for efficient revenue-raising, the effect of trade reforms on revenue was not highlighted since these were viewed as minor revenue sources. However, these points were not explicitly indicated in the context of the tariff recommendations, suggesting that the framework did not integrate protection and revenue objectives to the extent desirable.

ZAIRE: In Zaire, recommendations to narrow the range of tariffs by introducing a minimum tariff of 10 percent and a maximum tariff of 60 percent were expected to increase revenue by US\$11 million. The positive revenue effect of the increased minimum duty was expected to more than offset any decline from the lowering of high end tariffs. The measures were not effectively implemented so that it is not possible to assess the validity of these priors.

PHILIPPINES: The ex-ante revenue analysis of the tariff reform under SAL I estimated the revenue loss due to tariff reductions to be negligible and gave the following reasons for this conclusion: a) there would be little revenue loss from the reduction of the high tariff rates because the quantities imported at those rates were small, b) there may be a revenue gain from the increase in tariff rates on high volume items, and c) import liberalization would enable revenue to be earned on items formerly restrained by licensing requirements. Some positive revenue measures were nevertheless recommended: QRs on non-essential consumer imports were to be replaced by higher domestic commodity taxes to discourage consumption and were expected to raise P1 billion. New indirect taxes were planned and expected to raise P300 million in additional revenue.

Following these recommendations the average tariff rate was reduced from 43% in 1980 to 30% in 1982. Import values and tariff revenue in 1982 remained at the 1980 dollar levels suggesting that the tariff reform per se was indeed revenue neutral.⁴ However, the economy deteriorated in 1983-86 and the crisis caused the government to impose an across the board 3 percent import tax and a domestic transaction tax based on turnover. Import liberalization was stalled by the crisis but the tariff reforms were accomplished by 1985.

⁴ I am grateful to Erika Jorgensen for comments on an earlier draft that helped clarify this point.

PAKISTAN: The Bank funded an ERP study by the Pakistan Institute of Development Studies whose tariff recommendations were not accepted by the government largely because, in their view, it paid inadequate attention to the revenue and employment effects of the proposals. Subsequent analysis by the Bank considered the revenue and employment implications. It also recommended development of a broad-based sales tax to release the revenue constraint and enable further tariff reforms to proceed.

THAILAND: Revenue decline caused a reversal of previous tariff reductions in Thailand. A Bank review of SAL lending concluded that the Bank recommendations for revenue enhancement had focussed on one-time increases rather than elasticity-increasing tax reforms. It also suggested that short term revenue effects of tariff reduction may have been underestimated and contributed to policy reversal. An IMF study recommended tariff reductions to a level where they served a purely protective function. The revenue effects of these measures were expected to be compensated by reforms in domestic indirect taxation and the long term development of a consumption-type VAT.

TURKEY: In Turkey, the protection-reducing effect of tariff reforms over the period 1980-85 were partially offset by the introduction of a dollar denominated levy in 1985. While the Bank was separately recommending domestic tax reforms such as the introduction of the VAT, these were slow in being implemented. It is clear that the tariff reforms did not ease the fiscal pressure and may have contributed to the growth of surtaxes on trade earmarked to Extra Budgetary Funds. A subsequent study took more explicit note of the need to coordinate tariff reductions and tax reforms. The report observed that

"trade taxes are an inefficient revenue collection device because they introduce production distortions in addition to consumer price distortion. They are however

easy to collect. But now that Turkey has a well functioning VAT, which avoids production distortions, the latter argument holds with less force."

JAMAICA: In the latter half of the eighties, the responsibility for domestic tax reform in Jamaica rested with the USAID while the Bank and the Fund made trade regime recommendations. However, Bank analysis contains little discussion of the revenue effect of tariff reform and necessary adjustments in domestic tax rates. The only reference to any revenue impact was the observation that exempting input imports from customs duty reduced revenues and created pressure to increase income taxes to compensate. A subsequent discussion observed that implementing the scheduled VAT would allow further progress in tariff reforms but failed to indicate in what way the two were perceived to be related.

MOROCCO: The Bank recommended eliminating the Special Import Tax (SIT) and expected the revenue loss feared by the government to be offset by a 2 percent increase in the sales tax rate and the revenue from export income taxes. The anticipated increase in income taxes was a miscalculation and failed to materialize since both export income and agricultural income had previously been exempted from taxation. A subsequent tariff increase was due to the revenue shortfall on this account and the poor initial performance of the VAT.

MALAWI: Under SAL I and II, the Bank recommended shifting from taxing external transactions to taxing domestic transactions with the objective of broadening the tax base and lowering rates. These steps were designed to correct the problem of poor revenue performance. The government initially took a number of measures (increased tariffs across the board, and imposed duties and levies) not consistent with these objectives.

In 1985 the Bank suggested sweeping reforms in the tariff and tax structure involving a sharp reduction in the tariff rates and recommended increases in the domestic indirect tax rate to offset revenue loss. The Bank recommended i) eliminating import duties on non-competing imports (which constituted 80 percent of imports), and ii) reducing tariff rates on competing imports and intermediate goods. It was suggested that the rate of surtax (domestic indirect tax) be raised from 30 to 35 percent to offset the revenue loss from the tariff reduction. While the short term objective was revenue neutrality, the proposals were expected to increase tax elasticity in the longer run. In fact, as a result of delays in the implementation of tariff reductions, the short term effect on revenue was positive.

BANGLADESH: In 1987 a Bank study anticipated the impact of tariff reductions to be of the order of 2-3 percent of total tax revenue in the event the volume of imports remained the same. The study recommended that tax reforms should accompany the tariff reforms with the specific objective of generating revenue to offset the revenue lost from tariff reductions. The replacement of QRs by tariffs was recognized as a partial revenue offset. A subsequent study recommended wide ranging reforms designed to increase tax elasticity and improve revenue generation. Increased compliance under a regime with lowered tariffs was expected to increase revenue. A value added tax was introduced in July 1991 with positive revenue impact.

B. PROTECTION AND DOMESTIC TAXES

In most discussions of protection policy it is tacitly assumed that protection is provided by customs duties and/or QRs. This view overlooks the fact that domestic indirect taxes in developing countries frequently have an effect on protection because the tax rate on domestic goods and imports may not be identical. Even in cases where the statutory tax rates are equal, separate 'markup' factors may be used or the definition of the value base may be inappropriate so that protection to domestic production is affected. Exemption from sales taxes for selected domestic industries serves to add to the protection received by such industries. On the other hand, excise taxes often apply only to domestic goods and have the effect of reducing the protection given by the tariff structure. Reforms to the domestic indirect tax structure which address these aspects must therefore accompany tariff reforms designed to restructure protection. In the discussion below we focus on whether Bank studies seek to eliminate the protective effect of domestic taxes. It should be emphasized that tariffs continue to play a protective role in all the cases.

A number of studies included a comment on the need to reform features of the domestic indirect tax system that discriminated between imports and domestic items. However, the analysis underlying the proposals was often inadequate. In a few cases, initial studies identified elements of protection in the domestic tax system and recommended reforms. Subsequent analysis discovered additional elements of protection that had been overlooked. While a large number of reports did not discuss the issue at all, we cannot conclude that protection deriving from domestic indirect taxes was not relevant in these cases.

PHILIPPINES: Under SAL II in 1983 the Bank recommended the elimination of the protective element in the indirect tax system which derived from the differential treatment of imported and domestic goods. It was estimated that one third of the ERP for manufacturing was due to the protective effect of indirect taxes. Legislation was to be introduced to dismantle the advance sales tax in phases - in the first phase the differential markups for imports and domestic items were to be replaced by uniform rates. In the second phase the advance sales tax was to be displaced by a second stage sales tax with tax credit provisions. This tax would include higher rates for luxury products and constituted a step towards the introduction of a full fledged VAT. The excise tax was also to be restructured. Accordingly, in 1983 the specific tax on imported and local cigars, and high tax bracket cigarettes were made uniform and the tax differential on local and imported alcoholic drinks was reduced. The recently introduced VAT treats imports and domestic goods symmetrically.

ZAIRE: A higher rate of sales tax applied to imports than to domestic goods in Zaire and a study recommended equalizing the statutory tax rates on domestic and imported goods. However, subsequent studies have noted that because the sales tax on domestic goods is a cascading tax, the lower tax rate is justified.

BANGLADESH: In 1987 the Bank noted that the use of a sales tax that applied only to imports multiplied the number of effective tariff rates and recommended that this tax be eliminated by first reducing the number of rates, introducing a zero rate, and gradually shifting most imports to the zero rate. The study did not comment on the fact that the sales tax should serve a revenue and not a protective function. A subsequent analysis recommended the introduction of a manufacturing and import stage VAT to replace the existing excise and sales taxes on imports. This was expected to

feature symmetric treatment of domestic and imported goods. A VAT with these features was introduced in 1991.

GHANA: A number of different studies have recommended the adjustments required to achieve symmetrical domestic sales and excise tax treatment of imports and domestic goods in Ghana. Earlier reports addressed rate symmetry while later reports have discussed more subtle sources of discrimination. Until 1986, the sales tax rate on most domestic products was 10 percent whereas corresponding imports were subject to a 20 percent sales tax rate. A Bank mission estimated that a 20 percent consolidated sales tax on duty-exclusive manufacturing would also match the 20 percent sales tax on the duty exclusive value of imports.

Excise taxes in Ghana did not apply to imports in 1986 and thus discriminated against domestic products. The Bank recommended consolidating the excise on non-traditional items into the reformed sales tax which offered symmetric treatment of imports and domestic goods. Imports of the remaining excisable goods were also brought under the excise tax net at the same rates as domestic products thus eliminating the negative protection in the excise tax. Achievement of this sales and excise tax symmetry was seen to shift the protective function to the tariff.

One final wrinkle in the excise tax remained to be corrected. A 1988 mission noted that the excise tax is applied to imports on the excise tax exclusive (cif) price while domestic producers, owing to the history of price setting, are taxed on the excise tax inclusive price. Thus an element of discrimination against domestic producers remains in the excise tax. The report recommended using a common excise tax-exclusive basis for both import and domestic excise taxes to eliminate this discrimination.

MOROCCO: The Bank has recommended harmonization of the sales tax on domestic and imported goods in Morocco. One Bank report supported the IMF's recommendation that Morocco introduce a VAT and noted that some measures would facilitate this, such as lowering domestic taxes on imported products to the level of taxes on similar Moroccan products.

In 1984 the Bank made indirect tax proposals related to the harmonization of the sales tax treatment of domestic and imported goods, and measures to reduce cascading of the sales tax. In particular, it recommended abolishing differences in sales tax rates for domestic and imported goods.

MALAWI: In 1985 a report on Malawi recommended symmetric domestic tax treatment of imports and domestic items. At the time, the surtax applied at different rates on imports and domestic products; 30 percent of the duty inclusive price for imports and 25 percent of producer price for domestic goods. The import levy of 5 percent of the cif price and the import duty itself increased the differential tax treatment of domestic and imported products.

The report recommended that the complex system of import duties, levy, surtax and excise should be replaced almost entirely by a single tax, the surtax, applied at one flat basic tax rate on all commodities, domestic and imported, levied ex factory or at the point of import. The surtax was essentially a VAT since taxation of inputs would be avoided by allowing surtax paid on inputs to be credited against tax due on output. The elimination of input taxation implied that domestic industries would benefit from increased protection. To avoid this, tariffs on competing imports were reduced.

The existing structure was replaced with a two rate (0 and 35%) system that applied to imported and locally produced luxury goods symmetrically. Raising the surtax rates allowed the lowering of high tariffs and the elimination of import levies without loss of revenue. The integrated

determination of the surtax (VAT) and trade taxes in this case allowed an improvement in the incentive structure of the trade regime while creating a relatively non-distorting consumption tax for revenue generation. It should be noted however, that the excise tax applies only to domestic production and thus continues to have a negative-protection role.

THAILAND: The Bank's SALs did not raise issue with the differential application of domestic indirect taxes to imports and domestic products. By contrast, the IMF highlighted this issue in 1987, noting that the Business Tax assumed a protective function by taxing imports at a higher rate than domestic goods through the arbitrary and high assessment of profit margins on imported goods to determine the taxable price. Reforms were suggested to the business tax which would reduce this and other distortions and take the system towards the eventual objective of a consumption type VAT.

The excise tax also required correction of differential treatment of imports and domestic products. Since excise duties on imports were levied on a base consisting of c.i.f. plus customs duties plus mark-ups of arbitrary "standard" profit rates, they functioned as arbitrary instruments of protection. Imported beer and distilled spirits were taxed at a lower effective rate than local products (thus functioning as a "negative protection" instrument) while other imports were taxed at higher rates than domestic counterparts. The comparison of the effective excise tax on different items was also complicated by whether it was assessed on the retail or wholesale price and by the arbitrary process of price assessment - both for imported and domestic products. The IMF recommended rationalizing the excise tax value base and dismantling the protective and anti-protective function of this tax by imposing symmetric rates on imports and domestic products. The c.i.f. value plus customs duty for imports and the ex-factory manufacturer's price were recommended as appropriate tax bases for domestic products.

PAKISTAN: The domestic indirect tax structure in Pakistan did have a protection component which was addressed in various Bank studies. The domestic sales tax at one stage applied at different rates to domestic and imported goods and/or exempted a large class of domestic goods while taxing their imported counterparts. The excise tax had the opposite effect, of reducing protection, by applying only to domestic production of some goods. While the sales tax rates have been equalized the other features of the indirect tax system still need to be corrected.

JAMAICA: A study financed by the US-AID recommended a VAT (General Consumption Tax) for Jamaica which would consolidate the various internal levies into one broad based tax and treat imports and domestic goods similarly. While the study did not mention it, it was indicated elsewhere that some domestically produced goods were subject to the excise tax while corresponding imports were not.

INDONESIA: A limited VAT at the manufacturer's level was introduced by the Government in 1985 as part of a comprehensive tax reform and subsequently expanded to the wholesale level. The potential protective effect of the VAT was avoided by the symmetric treatment of imports and domestic goods under the VAT.

ZAMBIA: Zambia illustrates some of the complexity of identifying the protective effect of domestic indirect taxes. Prior to changes in 1985, the sales tax in Zambia applied to all imports (final and intermediate goods) but only to some domestic final goods. Moreover, imports were taxed at 12.5% while domestic goods were subject to a 10% sales tax rate. This structure of the sales tax was protective in three ways: (a) the rate differentiation protected all domestic import competing firms that were subject to the sales tax by an additional 2.5%, (b) domestic final goods not subject to the

sales tax were protected by the full amount of the 12.5% sales tax on imports, and (c) the sales tax applied to imported inputs but not to domestic input production, thus providing an additional 12.5% of sales tax protection to domestic input producers. In 1985, the Bank included a recommendation to unify the rates on imports and domestic goods at 15% and to expand the base of the sales tax to include all local final goods produced in significant amounts as part of its loan conditionality. This addressed points (a) and (b) above but neglected (c) and, by increasing the rate of the sales tax, increased the protective effect of the tax on input production. Tariff reforms that had recently increased the nominal tariffs on inputs to a minimum of 10%, citing the existence of low or zero rates on inputs, completely neglected to incorporate the tariff-like effect of the sales tax. The combined effect of the minimum tariff and the increase in the discriminatory sales tax rate was to raise the nominal protection to domestic input producers by a further 12.5%.

C. STRUCTURE OF TARIFFS

In the following section we review the consistency of Bank proposals with respect to tariff structure and ask whether these proposals corresponded in any way to the principles outlined in the 'rules of thumb' suggested by an integrated perspective.⁵ While all the country cases involved recommendations to dismantle QRs and import licensing restrictions and reduce tariffs, the specific recommendations differed in the details. The objective of most tariff proposals was to reduce the level and range of nominal tariffs and this was sought to be achieved by lowering maximum tariffs and establishing a narrow band within which all tariffs would lie. In some cases, minimum tariffs were to be raised. This strategy of compressing the tariff range has its logical culmination in a uniform tariff and in a number of cases this objective was stated explicitly. In one case a uniform

⁵ See page 3 for the rules of thumb.

ERP was recommended for a particular sector (Thailand). In a few cases the Bank recommended a uniform nominal tariff with additional time bound tariff protection for new/infant industries (Morocco, Thailand).

Two opposite concerns are expressed in some Bank studies, one of which sits uneasily with the general thrust of recommendations towards a uniform tariff. These have to do with the tariff treatment of inputs and the implications for protection of upstream and downstream industries. In a number of cases it was felt that tariff escalation (lower tariffs on inputs relative to outputs) contributed to excessive protection to downstream industries since ERPs were rendered greater than the nominal tariff. It was felt in the case of Thailand that the development of upstream industries was retarded if input tariffs were low while in the case of Zaire the Bank study noted that the high degree of tariff escalation created incentives for uneconomic assembly type industries. Raising the tariff on inputs while lowering final good tariffs was the recommended solution.

The opposite concern and implication for tariff structure was expressed in Pakistan and Indonesia where it was felt that high tariffs on inputs saddle downstream industries with high costs, lower the ERP, and retards downstream development. The implication in this case is to lower input tariffs although in other cases it may lead to suggestions to raise final good tariffs. In the case of Bangladesh the anomaly of higher tariffs on inputs than final goods was sought to be eliminated by lowering input tariffs.

PHILIPPINES: In 1980 the Bank recommended tariff reductions to lower the average ERP while narrowing the band between high and low tariffs. The Bank recommended tariff reform to reduce average ERPs and to narrow the range of nominal tariffs to a band of 10-50 percent. It also urged a phased program of liberalization of QRs on non-essential consumer imports and unclassified imports.

In 1987 the Bank attempted to initiate broad ranging reforms including the areas of taxation and trade as part of the Economic Recovery Loan. A further review of the tariff structure with the purpose of identifying areas for reform and potential for reducing tariff rates further was to be completed and a new tariff schedule was to be announced by end-1988, while the remaining items subject to QRs were to be liberalized.

THAILAND: In Thailand, a maximum and a minimum tariff were set and the SAL recommended eliminating the tariff exemption of capital intensive firms for the import of machinery. Later studies noted that the effect of these tariff changes was to greatly increase the ERPs for light intermediate manufactures and lower the ERP for heavy intermediate and investment goods. A subsequent SAL based its recommendations on the need to achieve uniform ERP across the electrical goods industry.

The IMF commented that the existence of tariff escalation, wherein the rates on raw materials and intermediate inputs were lower than those on final goods, implied that i) ERPs were high and widely dispersed, and ii) created a bias against the development of an indigenous base in these industries. The report recommended a) in the short term, a reduction of high tariffs to 50 percent, b) in the medium term, narrow the tariff band to lie between 4 and 20 percent, with only infant industries being allowed higher tariffs for a limited duration, and c) in the long term, a uniform tariff of 20 percent for purely protective purposes.

MALAWI: The Bank urged eliminating tariffs on non-competing imports and reducing the tariff on competing products and intermediate goods in a 1985 study. Since the new surtax would give credit for taxes paid on input purchase it would, ceteris paribus, increase the ERP to import competing products. To avoid this effect, tariffs on imports were reduced.

JAMAICA: A number of early reports on Jamaica indicate the lack of a systemic view of tariff reform. It appears that specific industries (footwear, garment, and construction) had been targeted for duty-free import of inputs. In 1983, however, the Bank urged a review of import duties and argued that the exclusion from duty of raw materials, intermediate inputs, and capital goods imports encouraged capital intensity. It suggested that such measures prompted increased taxes on income to replace foregone tariff revenue. As a condition of SAL II, the possibility of imposing duties on imports of raw materials and capital goods while rebating the duties to exporters was to be discussed.

A technical assistance loan in 1985 supported a study of Jamaican comparative advantage and the study recommended a flat rate uniform tariff of 25 percent. The government rejected this proposal and announced a decision to lower tariffs gradually until they corresponded to a 4-rate structure within a 5-30 percent band. This was to be achieved by lowering high rates and raising low rates. In 1987 a trade and finance SECAL included as a condition the review of restricted items by the Bank and the tariff reform committee. A maximum tariff of 60 percent and a minimum of 5 percent were also recommended. Since the nominal tariff was composed of the statutory tariff and so-called stamp duties, tariff reform had to simplify and rationalize this structure. The tariff on raw material and capital goods were to be set at 15 and 20 percent respectively.

TURKEY: The guiding objectives of a 1985 report were achievement of uniform ERPs across industries and the lowering of average tariffs to 7 percent. In 1987 a Bank study on Turkey commented that average tariffs on intermediate goods were lower than the average tariff on final goods and this indicated that effective protection for final goods production was higher than the nominal tariff rate. However, the report concluded that ERPs give no clear signal for tariff reform since distortion costs depend on nominal tariffs and not ERPs. ERPs may guide reform of the protective structure but this objective is better achieved by production subsidies rather than tariffs.

Turkey taxed capital goods imports at a high rate and the 1987 study recommended that, since this placed Turkish entrepreneurs at a disadvantage, this tariff be eliminated.

GHANA: In 1986 both the Fund and the Bank found the tariff structure in Ghana to be appropriate and recommended that the use of QRs be reduced. They noted that an overvalued exchange rate offset some of the protection provided by the tariff structure. A temporary across-the-board import surcharge was recommended to mop up scarcity premia due to quotas.

INDONESIA: A Bank report recommended eliminating QRs and gradually reducing tariffs while providing adjustment assistance to affected industries. Both the level and variance in ERPs were to be lowered over time. Tariffs on intermediate and final goods were to be lowered to encourage price competition and to reduce domestic costs. A subsequent report commented on tariff reforms undertaken by the government which reduced the maximum tariff (for all except 19 product groups) from 225% to 60%, reduced the number of tariff levels and the dispersion of rates. However, simultaneously, new QRs had been introduced. The report argued that the development of upstream industries through protection would raise costs for downstream industries and lower their effective protection. Future development should be along lines that would not require protection or subsidies. This required eliminating QRs and lowering tariffs.

In 1987, the Bank noted that recent government actions had reduced QRs and increased the relative importance of the need for tariff rationalization. Tariffs had been increased on certain of the intermediate and final goods which were freed from QRs. Other inputs had had tariff reductions. It was recommended that attention should now be paid to reducing tariffs on the outputs. The report emphasized the need for a tariff structure that restricted the range of tariffs to a narrow band.

The 1987 Trade Policy Adjustment loan recommended removal of QRs and their replacement by tariffs, the relaxation of import licensing restrictions on 110 items and their removal from 165 items. Tariffs on 152 items not produced locally were to be reduced to the 0-5 percent range and the maximum tariff was to be lowered to 60 percent. This TPA loan also included a recommendation to replace the sales tax with a VAT.

More recently, the Bank reviewed the reforms in tariff levels and reduction of QRs and recommended that an across-the-board tariff reduction would clarify the government's intention of achieving a low and narrow tariff structure. The Bank also noted that the primary objective of tariff policy should be to provide relatively low and consistent levels of protection across activities, rather than to generate revenues.

MOROCCO: The main recommendations in Morocco related to QR reduction in the 1979-82 period. A 1984 report recommended phasing out of the Special Import Tax (SIT) and achieving a lower maximum tariff. A ceiling ERP of 25 percent was also an object of this ITPA loan. The comprehensive trade study of 1984 recommended a phased program of QR elimination and reduction of tariffs with the intention of achieving a maximum ERP of 25 percent in 5 years. The study suggested that a higher level of tariff protection be allowed for new industries on a temporary basis.

ZAIRE: Reduction of the level and dispersion of tariffs was sought to be achieved in Zaire by the introduction of a minimum and a maximum tariff of 10 and 60 percent respectively with a timetable to reduce the maximum to 30 percent in 3 years. While the object of this exercise at one point was to achieve a uniform nominal tariff of 30 percent this was later amended to achieve a maximum tariff of 30 percent.

Issues Raised in World Bank Recommendations on Tariff Policy in Selected Countries											
	B A N G L A D E S H	G H A N A	I N D O N E S I A	J A M A I C A	M A L A W I	M O R O C C O	P A K I S T A N	P H I L I P P I N E S	T H A I L A N D	T U R K E Y	Z A I R E
ISSUES											
Revenue Effect of Tariff	X	X	NI	X	X	O	O,X	X	O,X	X	X
Protective Effect of Domestic Indirect Tax	X	X	X		X	X	X,O	X	O,X	X	X
Tariff Structure											
1. Lower Input Tariffs	X		X		X		X				
2. Reduce Tariff Range				X				X	X	X	X
3. Uniform Tariff				X		max 25			X	X	X

To provide a convenient and quick reference, the issues addressed by policy recommendations or relevant to the discussion in the country reports are identified with an "X" in the appropriate box in the table above. "NI" indicates that the item was not an issue. An "O" indicates that the issue was either overlooked or underestimated. Clearly, the text provides a more complete discussion and complements the broad picture above.

PAKISTAN: The Bank's recommendations in Pakistan have followed a two stage strategy of reform with the first stage devoted to eliminating QRs and various duty exemptions and concessions, and stage two proceeding to tariff range compression hand-in-hand with development of a broad based sales tax. The overall objective has been to attain a lower and less dispersed range of ERP. Regarding tariffs on inputs, a 1987 Bank report, in contrast to earlier reports, highlighted a concern with high tariffs on raw material imports which were retarding the growth of downstream industries by lowering their ERP. The same report recommended a minimum 10% tariff (to replace the existing import surcharge) and suggested "rationalizing" the structure of tariffs by setting rates of 10-20% for raw materials, 20-40% for intermediate inputs, and 40-60% for final goods.

BANGLADESH: The Bank's 1987 recommendations in Bangladesh consisted of suggestions to replace QRs with tariffs and to reduce the range and level of ERPs by reducing nominal tariffs. The number of tariff rates were sharply reduced and sales taxes that applied only to imports were slated for elimination. The assignment of products to different rates was found to be disorganized and was recommended for rationalization. Anomalies created by having higher tariffs on inputs than applied to final goods were sought to be eliminated. The 1988 report focussed on domestic tax reforms that were essential to release the revenue constraint and permit further tariff reform. It specifically recommended switching to a consumption based domestic tax (a manufacturing and import level VAT) and suggested that tariffs should be used only to provide time-bound protection to infant industries.

III. Conclusion

This review has focussed on the Bank's analysis and recommendations on a range of related issues: the revenue impact of tariff reforms, the role of domestic indirect taxes in protection, and the structure of protection. In principle these issues should be analysed using a common

integrating framework which efficiently matches instruments and objectives. Recognizing that tariffs have both a protection and revenue function while domestic indirect taxes are best used for revenue generation suggests a coordinated approach to tariff and tax reform. In particular, it is inadvisable to view tariffs purely as instruments for protection and to neglect their revenue function. Such an approach runs the risk of exacerbating fiscal deficits and jeopardizing both the tariff reform and stabilization objectives. Neglecting the protective effect of existing indirect taxes implies that tariff reforms may even fail to achieve protection objectives.

At the outset of this paper we defined what an integrated approach to taxes and tariffs might suggest as a desirable structure of these instruments. The general conclusion that emerges from the review is that such a public finance perspective is often not present in the Bank's recommendations on tariff reform.

- a) Revenue concerns are often not adequately addressed in the design of tariff proposals.
- b) The protective effect of domestic indirect taxes is often not recognized.
- c) While a few reports featured recommendations to introduce a uniform tariff, there appeared to be little consensus on a desirable tariff structure.

A. Tariffs and Revenue: The evidence on whether tariff reform proposals anticipated revenue effects is mixed but clearly suggests that there is scope for improving the quality of policy advice through more explicit consideration of revenue concerns.

The Bank, as noted earlier, has had a standard proposal which consisted of replacing QRs with tariffs and thereafter reducing tariffs. The typical response to short-term revenue concerns in the light of these proposals has been that revenue would not decline by much, if at all. The reason for this assessment has been that, while tariff reductions would lead to some revenue loss, it would be offset by additions to the tariff base caused by a) transferring QR items to the tariff list, b)

increased imports through legal channels, c) removal of existing exemptions, and d) introduction of a minimum tariff. On occasion, Bank reports recommended increasing the domestic sales tax (Morocco) or reducing the subsidy to domestic capital goods (Turkey) in an effort to offset revenue decline due to tariff reductions. In Zaire the revenue loss due to reduction of the maximum tariff was expected to be more than offset by an increase in the minimum tariff.

Few reports addressed the longer-term need to reduce the reliance on trade taxes for revenue. A report on Malawi recommended shifting the revenue function to the domestic indirect tax by broadening the base and elasticity of this tax while reducing tariffs on imports. A report on Bangladesh recommended moving towards the development of a manufacturing-cum-import stage VAT which would shoulder the burden of the revenue function by taxing consumption rather than imports and inputs.

Since much of the trade liberalization undertaken to date has focussed on replacing QRs with tariffs, which may be presumed to have been revenue enhancing, this neglect may not have been costly.⁶ Nevertheless, some cases of stalled reforms or policy reversal may be traced to revenue declines following tariff reforms. Future trade policy reforms are more likely to deal with tariff reductions that lose revenue and must give more prominence to developing revenue alternatives.

B. Protection and Domestic Taxes: The protective effect of domestic indirect taxes could emerge from a number of different channels and differences in the statutory tax rate is only the most obvious source. Indirect tax exemptions for domestic industries, differential 'markup' factors, and tax base definition are other more subtle sources of protection. While a number of reports indicated that the

⁶ Recent empirical work by Pritchett and Sethi (1992) suggests that even more than the tariff rates themselves, the scope of exemptions may play a significant role in determining revenue outcomes. The reduction of high end tariffs may have minimal adverse consequences for revenue if appropriate adjustments are made regarding the system of exemptions.

domestic indirect tax should feature symmetric treatment of imports and domestic goods, it was not obvious that this meant anything more profound than equal statutory tax rates. M o r e importantly, the failure to mention or discuss this issue in many country cases is probably an indication that it was not analysed, rather than evidence that domestic indirect taxes had no effect on protection. For example, an IMF-IBRD study on Thailand highlighted the existence of discriminatory taxation of imports under the Business tax which had not been addressed by earlier Bank work in the area.

C. Tariff Structure: While this review suggests that the Bank has often proposed replacing QRs with tariffs and almost always suggested that the level and the range of nominal tariffs be reduced, in few cases is a long term objective of reform spelt out beyond this limited prescription. Most studies are very disparate in their analysis and the recommendations indicate that there is little consensus on a desirable tariff structure.

In a number of cases the Bank suggested that the ultimate objective of tariff policy should be a uniform nominal tariff. In some cases increasing the tariff on inputs while lowering the maximum tariff (on final goods) is a method to approach a uniform nominal tariff objective. While the recommendation to narrow the tariff band is consistent with movement towards a uniform tariff, some Bank studies express concern over the reduced protection for downstream industries as a consequence of the necessary increase in tariffs on inputs. Others indicate that protection of upstream industries is needed and recommend raising input tariffs to achieve this objective. In many studies the suggested treatment is to increase the tariff on inputs to narrow the ERP on final goods while ensuring that there is some tariff escalation, i.e. final goods are taxed at a higher rate than inputs. One study (Turkey) expressed concern that tariff escalation causes final goods to have an ERP higher than the nominal tariff and recommended reducing final good tariffs on this account. Some amount

of confusion may thus be said to exist regarding the appropriate tariff structure given the lack of agreement in the recommended tariff treatment of raw material and intermediate inputs.

Summary: In conclusion:

- i) There is considerable scope to improve the quality of the Bank's tariff proposals by paying more attention to developing alternative tax instruments to offset the revenue effect of tariff reduction,
- ii) While the Bank has often recommended similar domestic tax treatment of imports and domestic goods it is apparent that the existing protective role of domestic indirect taxes is not always recognized in the design of tariffs,
- iii) While uniform tariffs were proposed in a few cases, there does not appear to be a consensus on what is an appropriate structure of tariffs. In particular, the tariff treatment of intermediate inputs provokes contradictory recommendations depending on whether priority is given to protecting upstream or downstream industries.

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